COPY

IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1935.

No. 238

[illegible], Commissioner of Internal Revenue,

Petitioner,

vs.

[illegible] Combs and Edward Everett, Trustees of L. E. Combs Well No. 1, Express Trust,

Respondents.

Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENTS.

[illegible]

Title Guarantee Bldg., 411 W. Fifth St., L. A.,

[illegible]

Title Ins. Bldg., 433 S. Spring St., Los Angeles,

Counsel for Respondents.

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IN THE

SUPREME COURT

OF THE

UNITED STATES.

OCTOBER TERM, 1935.

No. 238

Guy T. Helvering, Commissioner of Internal Revenue,

Petitioner,

vs.

E. E. Combs and Edward Everett, Trustees of E. E. Combs Well No. 2, Express Trust,

Respondents.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENTS.

PRELIMINARY STATEMENT.

Petitioner contended before the Board of Tax Appeals that respondents constitute an association taxable for income tax purposes as a corporation for the years 1925 and 1926. The Board denied petitioner's contention and held respondents taxable *not* as an association but as a trust. The Board in arriving at its decision said:

"There was but one and that a very limited enterprise. The beneficiaries had no power or control. *In none of the essential elements did the petitioner resemble a corporation either in form or operation.*" (Italics ours.) [R. 25.]

An appeal from the Board's decision was taken by petitioner to the Circuit Court of Appeals for the Ninth Circuit. That Court affirmed the decision of the Board, following in general the reasoning of the Board.

The same general question with which we are here concerned is involved in *Morrissey et al., Trustees, v. Helvering,* No. 17, October Term, 1935; in *Helvering v. Coleman-Gilbert Associates,* No. 78 and No. 79, October Term, 1935; and *Swanson et al. v. Helvering,* No. 108, October Term, 1935.

Petitioner in his brief herein has embodied by reference the contentions made by him in his briefs now on file with this Court in the above-mentioned cases. It is necessary for respondents herein, therefore, to refer to contentions made by the petitioner in said other cases referred to above.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered April 11th, 1935. [R. .....] A petition for a writ of certiorari was filed by petitioner July 11th, 1935, and was granted October 14th, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13th, 1935.

Statutes and Regulations Involved.

The Revenue Act of 1926, c. 27, 44 Stat. 9, applicable to the years herein involved, provides in part:

"Sec. 2 (a) When used in this Act—

. . . . . .

"(2) The term 'corporation' includes associations, joint-stock companies, and insurance companies. (U. S. C. App., Title 26, Sec. 1262.)"

The Regulations with which we are here concerned, namely, Articles 1502 and 1504 of Regulations 65 and 69, issued under the Revenue Acts of 1924 and 1926, are set forth in full in Appendix "A" to respondents' (petitioner herein) brief in *Morrissey et al., Trustees, v. Helvering*, No. 17, and need not be here repeated.

Petitioner's Contentions.

Petitioner herein contends that the decision of the Circuit Court of Appeals in this case should be reversed; that respondents did constitute an association taxable as a corporation for the calendar years 1925 and 1926. This contention is predicated upon the following specific propositions:

(a) That the sole test applicable in determining whether or not a trust is an association taxable for income tax purposes as a corporation is the "doing business" test (Resp. Brief, *Morrissey et al., Trustees, v. Helvering*, p. 6); that organization and operation in the manner and methods ordinarily adopted by corporations *is not essential to the existence* of an association.

(b) That if anything more than mere business activity is required, then such additional requirement is fulfilled if there exists *centralized control, continuity of existence, and limited liability.* (Resp. Brief, *Morrissey et al., Trustees, v. Helvering,* p. 7.)

Respondents' Contentions.

Respondents contend that they do not constitute an association taxable as a corporation. This contention is grounded upon two simple propositions:

(a) That an association subject to income tax as a corporation cannot exist unless *in addition to* business purpose there is *organization and operation* along the modes, methods, and manners ordinarily adopted by corporations.

(1) That any rule other than that above referred to would inevitably destroy the classification provided for by all Revenue Acts of various taxable entities; would produce uncertainty among taxpayers bordering on chaos; and instead of simplifying problems of taxation would result only in additional confusion.

(b) That respondents herein were neither organized nor did they operate in any sense of the word along the modes, methods, and manners ordinarily employed by corporations.

Statement of Facts.

Petitioner in his brief, pages 4 to 7, has fairly and fully stated the facts. We desire, however, to restate them briefly, drawing therefrom certain inferences which we submit are fully warranted:

(1) The Hub Oil Company was the owner of a certain oil lease subject to a royalty reserved to the lessor. [R. 35, 40.]

(2) One Combs, acting apparently with one Everett, desired to finance and drill *one* well on the property in conjunction with the Hub Oil Company and one Bailes. [R. 36-41.]

(3) *Prior* to the creation of the trust herein involved, Combs and Everett entered into an agreement with Bailes whereby Bailes was to furnish drilling equipment, drill pipe, drilling materials, and *to superintend the drilling and production operations until the well should be on commercial production.* For this Bailes was to receive 12% of the gross proceeds of the well. [R. 37.]

(4) The Hub Oil Company was to furnish a derrick, boilers, gas trap, etc. In case a producing well was brought in, the Hub Oil Company was to be paid the fair value of the property furnished. In case the project was unsuccessful, the Hub Oil Company had the right to remove the equipment from the property. As a matter of fact, from production the Hub Oil Company did receive for the equipment $15,000. In addition, the company reserved a percentage of the future gross production of the well. [R. 35, 37.]

(5) All the elements necessary in order to complete a producing well were thus provided for *in advance,* except the cost of labor, casing, and incidentals. These were to be furnished in one or both of two ways:

(a) Percentage interests in future gross production of the well less *pro rata* expense deductions were to be sold. [R. 38.]

(b) Such portion of the percentage of gross production retained by Combs personally as might be necessary was to be later sold by Combs in case the proceeds of the first sales of beneficial interests were insufficient. The proceeds of such sales were to be used for trust purposes and were not to revert to Combs personally. In effect, Combs *was required* to dispose of his entire personal interest and donate the proceeds back if necessary in order to prove the lease. [R. 39, 40.]

(6) Based upon the above, the trust instrument in question was drafted and signed. It was simple in the extreme. There was no name, no seal, no office, no principal place of business, no provision for removing or replacing trustees, no meeting of trustees or beneficiaries was provided for. The beneficiaries never held a meeting of any kind. There were no officers and no board of directors. [R. 35, 41.]

(7) The instrument provided that the Hub Oil Company and Bailes should receive percentages of gross production, whereas all those investing money received percentages based upon net production. Hub Oil and Bailes were not beneficiaries in the same sense as were those who put in cash, but were the owners of overriding royalties. They apparently participated, however, in the proceeds of the sale of the lease. The Hub Oil Company was also a creditor in case a producing well was brought in. [R. 37, 41.]

(8) A producing well was brought in in 1925. The *entire* proceeds of production, after the payment of expenses, were distributed to the various beneficiaries. [R.

40.] No depreciation or depletion reserve was ever set up or maintained.

(9) Whether or not certificates of beneficial interests were ever issued to the Hub Oil Company and/or Bailes does not appear from the record.

(10) But one lease was acquired and but one well was drilled. The trust indenture provided for but one lease and one well. [R. 36, 41.]

(11) The proceeds of production were paid to a bank and were by it actually handled and disbursed. [R. 40.]

(12) According to the record the beneficiaries were totally inactive and neither exercised nor had the power to exercise any sort of control over the trust.

(13) The record does not show what the activities of the trustees actually were. It may be assumed that they were slight, as Bailes was required to drill the well and superintend all operations until the well was on a commercial production basis. *There was apparently nothing done or to be done by the trustees except to furnish the money for the drilling operation and to later negotiate, in conjunction with other percentage owners, the sale of the lease.*

(14) In 1926 the lease was sold and the gross proceeds distributed. While the record does not specifically indicate either way, the presumption seems inescapable that the proceeds were distributed *pro rata* to all interested parties, including the Hub Oil Company and Bailes. Immediately after the sale the trust was terminated. [R. 35.]

(15) No money was ever borrowed in behalf of the trust and no activities other than those already detailed were ever engaged in.

ARGUMENT.

I.

Unless This Trust (A) Carried on Business for Profit and (B) Upon the Forms and Under the Modes and Methods Ordinarily Employed by Corporations, It Cannot Be Treated as an Association Taxable as a Corporation.

In this subdivision of our argument we will state what we believe the law of this case to be. It will be followed by a statement of the reasons why we consider such to be the law. We will also point out the results which we sincerely believe *must* follow the adoption of petitioner's contentions herein.

Before taking up our argument in chief, certain points are worthy of note:

(1) We are not here concerned with an excise tax levied against a corporation for the privilege of doing business. *Flint v. Stone Tracy Co.*, 220 U. S. 107, 31 S. Ct. 342 (1911), is not therefore directly in point.

(2) We are not here concerned with a stamp or capital stock tax. *Hecht v. Malley*, 265 U. S. 144, 44 S. Ct. 462 (1924).

(3) We are here concerned with an *income tax* for the calendar years 1925 and 1926.

The distinction, we submit, is important. Excise and capital stock taxes have, without exception, been levied against only one kind of taxable entity, namely, corporations. From the beginning our *Federal Income Tax Acts* have contemplated a number of dif-

ferent taxable entities including individuals, partnerships, trusts, estates, and corporations.

(4) Petitioner's contentions herein, if sustained, mean additional income taxes to the persons interested in this trust. The provisions of the 1924 Revenue Act taxing trusts, treat such trusts and the beneficiaries thereof as individuals. As such they are subject to the normal and the surtax provided by law. Under petitioner's contentions the corporate rate would be exacted from the trust as an entity. Distributions by the trust would then be taxed to the beneficiaries as dividends and would be subject to the surtax but exempt from the normal tax. The result is to increase the taxes due from the parties interested by the difference between the corporate and the normal tax rate for the years in question. This difference in favor of the Government is substantial.

(5) We are not here dealing with a case in which respondents seek to avoid the payment of any tax imposed against trusts or the beneficiaries thereof as such. So far as the record shows respondents filed returns and paid the taxes levied against trusts and the beneficiaries thereof by the applicable Revenue Act. Petitioner seeks to lift these persons out of the classification in which they believed they belonged and place them in another and more costly group.

Turning now to what we earnestly believe to be the *law of this case*, we submit the following:

(1) In no Revenue Act is the term "association" specifically defined.

(2) The term "association" as used in the various Revenue Acts was early held to be therein used in its *ordinary meaning.* In *Hecht v. Malley, supra,* in which the Acts of 1916 and 1918 were involved, this Court said, on page 157:

> "The word 'association' appears to be used in the Act in its ordinary meaning."

The Board of Tax Appeals has uniformly so held. *Philadelphia & Reading Relief Association,* 4 B. T. A. 713 (1926). This general rule of usage was very recently reaffirmed by the Tenth Circuit Court in *Commissioner v. Brouillard,* 70 F. (2d) 154 (1934).

(3) It is next important to determine what the *ordinary meaning* of the term *association* is. From this meaning we derive the tests heretofore referred to as to what constitutes an association. This meaning seems well established.

> "In the United States this term is used to signify a body of persons united without a charter but upon the methods and forms used by incorporated bodies for the prosecution of some enterprise." 1 Bouvier's Law Dictionary (Raule's Third Revision) 269.

In *Hecht v. Malley, supra,* this Court approved the above definition almost *verbatim:*

> "It (association) has been defined as a term 'used throughout the United States to signify a body of persons united without a charter but upon the forms and methods used by incorporated bodies for the prosecution of some common enterprise, . . .'"

Subsequently this Court reaffirmed the definition adopted in the *Hecht* case and specifically pointed out the necessity for quasi-corporate form of organization and operation. See *Burk-Waggoner Oil Asso. v. Hopkins,* 269 U. S. 110, 46 S. Ct. 48 (1925). In that case this Court said (p. 113):

> "Unincorporated joint-stock associations although technically partnerships under the law of many states, are not in common parlance referred to as such. They have usually a fixed capital stock divided into shares represented by certificates transferable only upon the books of the company; manage their affairs by a board of directors and executive officers and *conduct their business in the general form and mode of procedure of a corporation. Because of this resemblance in form and effectiveness these business organizations are subjected by the Act to these taxes as corporations.*" (Italics ours.)

Regardless of the specific applicability of the decisions of this Court in the cases of *Crocker v. Malley,* 249 U. S. 223, 39 S. Ct. 270 (1919); *Hecht v. Malley, supra;* and *Burk-Waggoner Oil Asso. v. Hopkins, supra,* it is submitted without qualification that in those cases this Court (a) adopted and approved the long accepted definition of the term "association," and (b) applied this definition to the Federal Revenue Acts with which this Court was there concerned.

Since 1925 this Court has not spoken on this point with respect to *income tax liability.* We know of no reason why this Court in the cases now pending before it should depart from the principles heretofore enunciated.

The Board of Tax Appeals has likewise repeatedly and *uniformly* applied the ordinary meaning test above referred to in determining whether or not a trust constitutes an association. In *Fred T. Murphy et al., Trustees,* 25 B. T. A. 724 (1932), the Board said:

> "An 'association' is an unincorporated body of persons organized in the general form of a corporation and employing corporate methods in carrying on a business for profit."

In *Morriss Realty Trust No. 1,* 23 B. T. A. 1076 (1931), the Board, in defining an association, said:

> "There is a triple test involving (a) business purpose; (b) business operations; and (c) quasi-corporate structure."

We submit that the principles laid down by this Court in the three cases heretofore referred to have been followed with practical unanimity by the various Circuit Courts of Appeal which have had occasion to pass on this question. If in the beginning any doubt existed as to the application of the *dual test* of business purpose and organization and operation along the modes, methods, and manners of a corporation contended for by respondents, then that doubt has been recently resolved against petitioner and in favor of respondents.

Respondent (petitioner herein) in Appendix "B" to his brief in *Morrissey et al., Trustees, v. Helvering,* No. 17, refers to certain decisions of various Circuit Courts. On page 20 of said brief he admits that the Circuit Courts of Appeal for the First, Fifth, Seventh, and Tenth Circuits have insisted upon said dual test. It is also admitted that since the decision of the Ninth Circuit in the instant

case it may be assumed that that Circuit has adopted the majority view.

Petitioner contends, however, that the Circuit Courts of appeal for the Second and Third Circuits have "consistently relied upon the business test as conclusive." (Resp. Brief, *Morrissey et al., Trustees, v. Helvering,* p. 20.) With this contention we do not agree.

In the case of *Allen v. Commissioner,* 49 F. (2d) 716 (1931), certiorari denied 284 U. S. 655, 52 S. Ct. 34 (1931), the Circuit Court of Appeals for the Second Circuit simply held that the trust in question was not engaged in business. There was hence no occasion for it to determine whether or not the trust was organized and operated along the modes, methods, and manners ordinarily employed by corporations.

In *Ittleson v. Anderson,* 67 F. (2d) 323 (1934), a capital stock tax case, the Second Circuit apparently recognized the requirement for quasi-corporate form. In rejecting of the contention that an association could not there exist because the trust had but one beneficiary, the Court said:

> "Usually there are a number of beneficiaries in a business trust, but there is no reason to say that every business trust must have more than one beneficiary at all times. *This tax is a special excise on the privilege of doing business in a certain form. The test is whether or not business is being conducted in a quasi-corporate form.*" (Italics ours.)

Respondent (petitioner herein) also refers in his Appendix "B" to said Morrissey brief to the decision of the Board of Tax Appeals in *Investment Trust of Mutual Investment Co. v. Commissioner,* 27 B. T. A. 1322 (1933),

affirmed *per curiam* by the Second Circuit Court, 71 F. (2d) 1009 (1934). It is significant to note that the Board in its opinion said, page 1328:

> ". . . there are three tests for determining whether an organization is to be classified as one or the other: (1) business purpose; (2) business operations; (3) quasi-corporate structure."

We likewise submit that the Third Circuit Court of Appeals has recognized the dual test herein contended for. In *Little Four Oil & Gas Co. v. Lewellyn,* 35 F. (2d) 149 (1929), certiorari denied 280 U. S. 613, 50 S. Ct. 162 (1930), the Third Circuit Court in the concluding paragraph of its opinion said:

> ". . . the Collectors were right in regarding this organization, however named, as an unincorporated association conducting a business for profit in *quasi-corporate form* . . ." (Italics ours.)

In *Smith v. Commissioner,* 69 F. (2d) 911 (1934), certiorari denied 293 U. S. 561, 55 S. Ct. 73 (1934), the Third Circuit Court said:

> "The test laid down by this Court in Little Four Oil & Gas Co. v. Lewellyn . . . is that if the trust is a business concern and if the shareholders or trustees, or both combined are operating it in active business for profit, the trust is in effect an association taxable as a 'corporation.'"

The term "business concern," we believe, specifically contemplates quasi-corporate organization.

It is submitted that the Second and Third Circuit Courts have in fact recognized in association cases the dual test theory contended for by respondents.

If any Circuit Court has in the past relied upon business purpose as the sole test, it was the Ninth Circuit in the decisions handed down by it prior to that in the instant case. Since that Circuit in the instant case recognized the dual test here contended for, we believe that practical unanimity among the various Circuits on this question now exists.

Not only have the courts adopted the dual test and dual requirement above referred to, but the most authoritative text writers, after careful examination of all applicable law, have come to the same conclusions. In *Paul & Mertens Law of Federal Income Taxation*, Callaghan & Co., 1934, volume 4, page 249 *et seq.*, it is said:

> "Probably the two most important considerations in determining whether a particular organization is taxable as an association are:
>
> (1) the character of the organization's activities, often called the 'profit' test, and
>
> (2) whether it has a quasi-corporate form and mode of procedure.
>
> "Where both requirements are present the organization is taxable as an association. These requirements may on occasion blend and become largely indistinguishable. *The second element must, however, be present.* A large number of trusts, joint ventures and partnerships would be taxed as corporations, if the only test was whether the entity was carrying on business for profit. . . ." (Italics ours.)

It is submitted that the *law of this case* is clear. A trust is not an association taxable for income tax purposes as a corporation unless there exists (a) business purpose,

and in addition (b) organization and operation along the modes, methods, and manners ordinarily employed by corporations.

We may turn now to a consideration of the Regulations issued by the Commissioner of Internal Revenue under the various Revenue Acts. These Regulations petitioner contends are in accordance with the statute and have, through constant readoption, established the single test theory asserted by him.

(1) It is submitted that these Regulations, even though they may, in general, follow the statute, will be of little assistance to the Court in its interpretation thereof.

The Regulations issued under the various Acts have lacked that uniformity of interpretation necessary in order to lend to them the weight of law. This fact is best evidenced by an examination of the various Treasury Regulations issued in connection with the so-called "control" theory. Article 1504 of Regulations 45 issued under the 1918 Act in defining an association and distinguishing it from a trust said nothing about control as such. The only mention thereof was indirect and appears in the last sentence of that Article, as follows:

> "If, however, the *cestui que trust* have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute."

The same Article was reenacted without change in Regulations 62 issued under the Revenue Act of 1921. In 1924, however, after the decision of the Supreme Court in the *Hecht* case, the Treasury Department amended Regulations 65 issued under the Revenue Act of 1924 to provide

that in case of control by the beneficiaries of a trust, an association existed and that even in absence of control an association existed in certain other cases. As was pointed out by the Treasury Department in a brief filed with the Ninth Circuit Court in the case of *Sloan v. Commissioner*, 63 F. (2d) 666 (133):

> "The entire administrative viewpoint was changed by the decision of the Supreme Court in *Hecht v. Malley*, 265 U. S. 144."

Here we have the origin of the control theory which has troubled the courts and Treasury for so many years.

Regulations 65 as above amended were re-enacted in Regulations 69 and 74 issued under the 1926 and 1928 Acts respectively.

In the meantime, however, various courts had questioned the soundness of the so-called "control" test. Typical was that of the First Circuit in *White v. Hornblower*, 27 F. (2d) 777 (1927), where the Court said:

> "The powers of the certificate holders . . . are significant only as they tend to show whether what the interested parties did amounted to forming themselves into an association . . ."

Accordingly, when Regulations 77 were issued under the Revenue Act of 1932, all reference to control as a test was eliminated. In other words, the *Treasury Department without any statutory change whatsoever has abandoned entirely the control theory.*

The above recital demonstrates clearly the fallacy of lending too great legal weight to Administrative Regulations. If the Regulations issued under the 1928 Act and defining control are to be deemed the equivalent of law,

then the Secretary of the Treasury without statutory authority himself changed the law when he issued the 1932 Regulations which made no mention of control. Obviously this cannot be true.

The Regulations, it is submitted, can in no event amount to more than the Treasury's interpretation of the statute as Congress enacts it. This was pointed out without qualification by the First Circuit Court in *Commissioner v. Kelley*, 74 F. (2d) 71 (1934), where the Court said:

> "No absolute rule of such classification has yet been laid down by the Supreme Court and the Regulations of the Treasury Department, 74, Art. 1314, cannot be held to be exclusive in defining the line between a trust and an association."

(2) As a matter of fact, the Regulations in effect during the years 1925 and 1926 must be deemed to fully recognize the two-fold test contended for by respondents. The Regulations in effect during those years are admittedly based upon the decision of this Court in the *Hecht* case, *supra*. The *Hecht* case admittedly employs the dual test of business purpose and quasi-corporate form of organization and method of operation.

Nor are the Regulations as actually drafted for those years in conflict with the principles herein contended for. Article 1502 of Regulations 45, issued under the Act of 1918, provides in part:

> "Associations and joint-stock companies include associations, common law trusts, and organizations by whatever name known which act or do business in an *organized* capacity, . . . the net income of

which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds. . . ." (Italics ours.)

The above provision has been readopted without substantial change in all subsequent Regulations down to and including the Regulations issued under the 1932 Act. It is submitted that the above definition recognizes both the business and the quasi-corporate form of organization and method of operation tests although it probably underemphasizes the importance of the latter. Had these Regulations confined themselves to the Article just quoted, which was simply a definition of the word "association," much of the confusion of the last ten years might have been avoided.

The difficulties into which the Treasury and the courts have fallen have been due in the main, it is submitted, to the Treasury's attempt in subsequent Articles of the same Regulations to *distinguish associations from other taxable entities such as partnerships and trusts.* (See Articles 1503 and 1504 of Regulations 45 and similar Articles of subsequent Regulations.)

An examination of the various Regulations issued by the Treasury Department in which the term "association" is defined or distinguished, indicates beyond doubt a tendency to widen the field of application of that term, which tendency has increased greatly with the passing years. (Compare Articles 1502 and 1504 issued under the Revenue Act of 1924 with Articles 801-2 and 801-3 of Regulations 86 issued under the Revenue Act of 1934, respondent's (petitioner herein) brief, *Morrissey et al., Trustees, v. Helvering,* No. 17.)

II.

To Apply the Test Contended for by Petitioner Is to Destroy the Long Established Statutory Distinction Between Taxable Entities and to Produce Further Confusion Among Taxpayers.

In the discussion which follows we propose to examine petitioner's contentions with a view to determining if possible:

(1) Whether or not they are sound and consistent with established concepts of Federal income taxation.

(2) Whether or not their application will result in the simplification of what is admittedly a difficult problem of interpretation and administration.

We submit without qualification, (1) that the petitioner's theories with respect to the taxability of this trust as an association are totally at variance with long established income tax concepts, and (2) that these theories, if applied, instead of simplifying our present problem will result in even greater confusion.

(1) With regard to the first of the above points we believe the following to be true:

(a) That petitioner's contention that business purpose alone transforms a trust into an association, is contrary to the classic common law conception of the term "association."

(b) That it results in increased income tax liability without clear or specific statutory authority therefor. It is too well established to require comment that taxing statutes, in case of doubt, are to be most strongly construed against the Government and in favor of the taxpayer. *Gould v. Gould*, 245 U. S. 151, 153, 38 S. Ct. 53 (1917).

This point is vital and worthy of further elaboration. Since 1913 all Federal Revenue Acts *for income tax purposes* have specifically provided for a number of *different* taxable entities. Among these different entities are individuals, trusts, estates, partnerships, and corporations. Each statute has provided for a specific method of taxing each entity. Each statute has provided certain rights, liabilities, and exemptions for each entity, and these rights, liabilities, and exemptions have differed as the entities have differed.

Section 219 of the Revenue Act of 1926 provides in part:

> "(a) The tax imposed by Parts I and II of this title shall apply to the income of estates or of *any kind of property held in trust, including*—
>
> "(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;
>
> "(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;
>
> "(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and
>
> "(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated." (Italics ours.)

Petitioner contends that the above Section of the statute is intended to apply only to trusts which are "engaged merely in collecting the income and conserving the property against the day when it is to be distributed to the beneficiaries." (Resp. Brief, *Morrissey et al., Trustees, v. Helvering*, p. 6.)

In making this contention, the petitioner points neither to statutory language nor legislative history. It is submitted that his contention in this particular is without foundation. In ten Revenue Acts and over a period of more than twenty years the statutory provisions with respect to trusts have remained more or less constant. It would have been exceedingly simple for Congress to have limited by statute the application of the trust provisions of the various Acts to the class of cases referred to by petitioner. Instead, the provisions of the statute with respect to trusts have remained almost identical.

It is contended by petitioner that the term "corporation" is defined in the Revenue Act of 1926 as "including associations, joint stock companies, and insurance companies," and that this definition applies wherever that term appears in said Act. We submit that this position is entirely untenable.

If the petitioner's contention in this respect is sound and a trust engaged in business is subject to tax as a corporation, then said trust should be subject to all the other provisions of statute governing corporations. *But this cannot be true.* A few examples only are necessary:

(1) Section 220 of the Revenue Act of 1926 imposed heavy penalties on corporations which permitted their surplus to accumulate beyond the

reasonable needs of the business. All Revenue Acts have contained similar provisions. It is too well known to require comment that some trusts which are not merely "dry" trusts were formed for the very *purpose* of accumulating income. Yet the Treasury Department has never attempted to apply these penalty provisions of the statute to accumulations of such trusts, regardless of whether or not they were engaged in business.

(2) Section 203 of the Revenue Act of 1926 contains many complex provisions governing the reorganization of corporations. Other Acts have contained similar provisions. There is no provision in that Section exempting its application to trusts which may constitute associations. If a trust is a corporation for the purpose of the income tax, no good reason exists why it should not be a corporation for the purpose of the statutory provisions relative to the reorganization of corporations. Yet the Treasury has never applied these provisions of law to anything except corporations formed under the laws of some particular sovereignty. It is too obvious to require comment that to attempt to apply these provisions of the statute to a trust such as we are here dealing with would involve all parties in utter confusion.

These instances might be multiplied. It is believed that it is unnecessary to make further reference to the petitioner's own inconsistency in applying his concept of an association to all of the varied problems which arise under our Revenue Acts.

What has heretofore been said has had special reference to trusts. It is, however, equally applicable to estates, partnerships, and joint adventures. They all engage in *business*. There is no reason why the petitioner's test as to what constitutes an association should be applied to trusts and ignored with respect to the other taxable entities referred to above.

If the matters which we have here undertaken to emphasize have any merit, it must be this: *The petitioner has no right to lift out of the classification as a trust, the entity with which we are here concerned and place it in another specific statutory classification and tax it as a corporation, unless the statute clearly so provides.* We sincerely believe that the above principle is sound. We believe that it was approved by this Court in *Crocker v. Malley, supra,* when the Court, in refusing to tax a Massachusetts trust as an association, said:

> "This opinion is based primarily upon the view that the Income Tax Act, considering its purpose, did not show a clear intention to impose upon the trustees, as an 'association,' a double liability in reference to the dividends on stock in the corporation that itself paid an income tax, *when, considered, as 'trustees', they were, by another provision of the Act, exempt from such payment.* . . ." (Italics ours.)

The above case has been repeatedly cited and often misconstrued. We submit, however, that it stands squarely for the principle of statutory construction set forth and is clearly applicable to cases such as the one at bar.

We submit that petitioner in contending that a trust is taxable as an association if it engages in business, regardless of the method of organization or the manner in which it conducts its business, is contending for a principle that is both unsound and unreasonable.

But petitioner himself does not have implicit faith in his position. (Resp. Brief, *Morrissey, et al., Trustees v. Helvering*, p. 21.) Petitioner suggests that the requirements as to form and method of operation, however, are met where there exists "some or all of the elements of centralized control, limited liability, and continuity of business."

We do not accept the above as complying with the second of the tests laid down for the existence of an association. *They do not go far enough.* Centralized control and continuity of business existence are more or less present in all partnerships and all trusts. In most "dry" trusts the beneficiaries may sell or encumber their beneficial interests. In practically all trusts centralized control lies with the trustees. Most partnerships have a managing partner, while in all partnerships involving "silent" partners, the general partners have control.

Limited liability is provided for in many instruments, yet it may exist only in the minds of the parties thereto. Limited liability does not exist and is not an advantage unless it exists *in fact and in law.* This Court may take judicial notice of the fact that many unincorporated groups have thought limited liability applicable to them but found to their sorrow that in law it did not exist. Except in rare instances, limited

liability *in law* exists only in the case of statutory corporations.

Finally, petitioner contends that we must not sacrifice substance to form; that what respondents herein are contending for are matters of form. *But we believe these matters of form are in this case matters of substance.* Petitioner, we submit, would destroy substance by merging in one all taxable entities involving more than one person where business is a feature. We insist that the *form* of the various Revenue Acts must be preserved. This form can only be preserved if the taxable entities therein provided for are maintained.

We believe that not only is the petitioner wrong in contending that business purpose is the sound test in fixing the identity of an association, but we believe that he is wrong in contending that quasi-corporate form and method of operation is satisfied if there exists centralized control, limited liability, and continuity of business existence.

(2) We have but one more problem to consider in connection with petitioner's contentions: If adopted by this Court will they simplify the administration of our taxing statutes. We submit that his contentions, if followed, instead of simplifying our problem will add confusion to confusion.

If we assume that all trusts are subject to tax as associations, provided only there exists a "business purpose," there remains the very troublesome question as to what constitutes "doing business." The complexity of that problem is too well settled to require elaboration here.

But even if that problem can be satisfactorily answered, there remains the question as to how far this test will be extended and to what entities it will be applied. As heretofore pointed out, if doing business is the sole test there is no reason why it should be limited in its application to trusts. As the need for revenue grows the Treasury will undoubtedly seek to extend the principle to partnerships, estates, and joint adventures. The constantly increasing number of cases in which a group of individuals has been found by the Treasury to constitute an association taxable as a corporation is the best evidence of the truth of this assertion.

The result would mean chaos and utter confusion in the ranks of taxpayers. It would mean that the Treasury Department could come back at any time against any entity which it deemed an association and tax it as such. The statute of limitations would be no bar because no return as a corporation would have been filed by said entity. If the Treasury were successful in its contention, a tax as a corporation could be collected from said entity at a time when the persons interested therein could not recover because of the statute of limitations any prior overpayment of taxes resulting from this change of classification. The situation which might develop is not only confusing; it is fraught with danger.

Nor does petitioner's contention that the requirement of corporate form and method of operation is satisfied by centralized control, limited liability, and continuity of business, solve the problem. It is difficult to conceive of elements more intangible in nature or difficult of interpretation than those just mentioned.

To say that a trust to be taxable as an association must in addition to doing business be organized and operated

along the modes, methods, and manners of a corporation does not impose an undue burden on our courts. All courts and all lawyers are familiar with the modes, methods, and manners of corporations. To apply that criterion to a given case involves no more difficulties than arise constantly in other cases. Certainly it would seem easier to apply that test than the tests contended for by petitioner.

It is submitted that the theories contended for by petitioner are not only unsound and inconsistent with our established body of tax law, but would involve the taxpayers of the country, as well as the administrative officials of the Treasury Department, in hopeless confusion.

III

This Trust Is Not an Association Because It Was Neither Organized nor Operated Along the Forms, Methods, and Manners of a Corporation.

Petitioner, in his brief, assumes that we concede that this trust was doing business. (Pet. Brief, p. 7.) Such is not the case. We do not propose here, however, to indulge in any extended argument on that point. We deem it unnecessary to a decision of this controversy.

It is submitted that our assertion that respondents herein are not taxable as an association because neither organized nor operated along the forms, modes and methods of a corporation must inevitably follow if our case is approached in the fashion adopted by the Fifth Circuit Court of Appeals in the similar case of *Lucas v. Extension Oil Company*, 47 F. (2d) 65 (1931). There the Court, in affirming a decision of the Board of Tax Appeals which had held the trust in question not to be an association, said:

"The Board of Tax Appeals in a careful opinion, balancing the resemblances which petitioner in its structure bore to a trust, against those which it bore to a corporation, and considering also the facts as to what the petitioner actually did, *found as a fact* and concluded as a matter of law that petitioner was not an association within the meaning of the taxing act 'voluntarily organized to transact business under corporate forms and transacting such business.'" (Italics ours.)

A balancing of resemblances such as above described discloses *in the instant* case an almost complete lack of corporate form of organization.

(1) Corporations ordinarily have at least three directors; even assuming that the trustees of this trust could be deemed directors, there were but two trustees. Corporate directors are elected annually by the stockholders; the trustees of this trust were appointed for the duration of the trust, and upon the death, resignation, or refusal to act of one, the remaining trustee was authorized to carry on alone. Corporations act through officers; this trust admittedly had none. Corporations have by-laws, seals, names, offices, and places of business; this trust had none of these corporate indicia. Corporate directors and stockholders have meetings and places of meeting; neither the beneficiaries nor trustees of this trust met or had places of meeting.

It is inescapable that all that happened in this case was that two trustees took title to a lease. When they acquired such title the production was subject to royalties and overriding royalties. A contract for the drilling of the well and superintending operations until commercial production was attained *had been entered into prior to the*

creation of the trust. There was nothing for the trustees to do except provide a certain amount of money for labor, casing and incidentals. After the well was on production they did not even act as fiscal agents as the Bank of Italy received and disbursed all moneys. Apparently the only thing of importance which the trustees had to do was to negotiate the sale of the lease. Even with respect to this point, in view of the fact that 29.667% of the gross production of the lease was held by other parties, it is quite apparent, although the record does not specifically disclose it, that these other parties, in addition to the trustees, had an interest in the negotiations.

In this case no provision was made for the determination of *net income* as that term is ordinarily understood in an accounting sense. There was no provision for a depreciation or depletion reserve. Instead, the entire production less necessary operating expenses was immediately distributable and was actually distributed.

Within a year after the well came into production, the lease was sold and the gross proceeds were distributed *pro rata* not only to the beneficiaries but so far as the record shows to the other persons interested in the lease.

In this case there *was not a continuous business venture.* Instead, there was involved only the liquidation of a wasting asset under a single lease. Only one well and one lease was provided for. Scope of activity and duration of life was necessarily limited. That continued enterprise is an important indicium of a corporation has been repeatedly recognized. In *Commissioner v. Kelley, supra,* the Court said:

"Corporate forms are used ordinarily to secure continued existence of the entity; here, the purpose was temporary, and as soon as accomplished the trust was terminated and the partnership form revived."

See, also,

Lucas v. Extension Oil Company, supra.

It is not necessary to burden this Court with further examples of corporate dissimilarities. We trust that it will not be deemed an exaggeration if we say that such dissimilarity exists with respect to every essential detail.

Petitioner contends (Brief p. 8) that continuity of existence and limited liability constitute sufficient resemblance on the part of respondents to a corporation to render them subject to tax.

We do not concede, as has heretofore been pointed out, that continuity of existence and limited liability constitute sufficient corporate resemblance to satisfy the tests required by the general law.

As we have stated, continuity of existence, as evidenced by the transferability of certificates of beneficial interest, is equally applicable to so-called "dry" trusts, which petitioners concede do not constitute associations subject to tax as corporations.

Limited liability may be provided for in the trust indenture, but it by no means follows that such liability actually exists in law and in fact. Limited liability, as that term is applied to corporations, exists only by virtue of statutory law. We have no such limited liability in this case.

The trust agreement, it is submitted, resembles a corporate charter in no fundamental particular. The powers

given the trustees are not those ordinarily provided for with respect to directors. The so-called certificates of beneficial interest do nothing more than prescribe the participation of certain of the people interested in the enterprise.

(2) With respect to *methods of operation*, it is submitted that respondents at no time conducted their activities in a manner even remotely resembling that of a corporation.

So far as this element is concerned, petitioner in his brief (p. 8) states: "The business of the trust was conducted by the trustees for the beneficiaries." There is nothing novel in this statement. We presume it to be true of every trust, of every estate, and of every partnership containing limited partners. It by no means follows that the activities of respondents herein were conducted along the modes, methods and manners of a corporation and that, therefore, they are taxable as a corporation.

It is necessary here to point out one more fact. Respondents herein *did not* resemble the entities with which this Court was dealing in *Hecht v. Malley, supra*, and *Burke-Waggoner Oil Association v. Hopkins, supra*. It would unduly prolong this discussion to point out the dissimilarities. Suffice it to say that the trust with which we are here concerned resembled the entities involved in those cases in no substantial particular.

It is not necessary to further burden this Court with a recital of the differences between this trust and the ordinary business corporation. It is sufficient to say that

counsel have examined recorded decisions involving oil trusts, both by the Board of Tax Appeals and the various Federal Courts. *We know of no case where any court or the Board has held an oil trust so lacking in corporate indicia as this to be taxable as an association.* On the other hand we feel confident that this Court will agree that in many cases the courts and Board of Tax Appeals have held oil and other trusts not to be associations where far more of the indicia of corporate form and method of operation existed than in the instant case. A few only of these cases need be cited.

In *Commissioner v. Kelley, supra,* there was a corporate name, Union Paste Company; a president and treasurer, and a clerk; a seal; the power to purchase property; a place of business; and a business susceptible of continuous operation. Nevertheless, the Court held that there was no quasi-corporate form and hence no association.

In *Commissioner v. Brouillard, supra,* the Iowa-Burk Syndicate was engaged in developing an oil lease and had corporate indicia and activities as follows: Four men owned an oil lease. They lacked capital to develop it. They formed a syndicate, naming three trustees to hold title to a one-half interest in the lease. The trustees sold interests for $30,000, entitling the 110 holders to a one-half interest in the venture. Certificates were issued to some of the holders. The certificate holders named one of the trustees. One meeting of the certificate holders was held. A bank account was kept. The syndicate kept books. A well was drilled and oil struck. Two additional

wells were drilled on borrowed money. The lease was then sold.

The Court held that the above trust was not an association taxable as a corporation.

In *Lucas v. Extension Oil Co., supra,* five men owned an oil lease; they created a trust under the name of Extension Oil Company, named four trustees, divided the trust estate into 400 units. There were seventeen beneficiaries, who contributed about $10,000. A well was drilled which produced oil. The proceeds were distributed. The following year the lease was sold and the trust terminated. A bookkeeper was employed who also handled the money. The Court held that the trust was not transacting business under "corporate forms."

In *Tyson v. Commissioner,* 68 F. (2d) 584 (C. C. A. 7th, 1934), certiorari denied 292 U. S. 657, 54 S. Ct. 865 (1934), three trustees took charge of a fund of money and purchased improved property, which was under lease. An agent was employed to collect rentals and manage the property. The trustees met. Dividends were paid every six months. The trustees set aside a depreciation fund of $5,000 which they invested in bonds. The property was sold in one of the three taxable years, after the beneficiaries had been orally consulted. A substantial profit was realized on the sale. The Court held there was no association.

In *Lansdowne Realty Trust v. Commissioner,* 50 F. (2d) 56 (1931), four trustees took title to property subject to a lease. The trust might last twenty years. The

trustees were to hold and manage the property, distribute the income, acquire other property if advisable, borrow money and employ agents, attorneys, etc. The trustees were to keep books and make reports to the beneficiaries. They were compensated for their services. A majority of the trustees could act in the absence of one. Vacancies in the office of trustee could be filled by the remaining trustees, with the written assent of the holders of a majority in amount of the beneficial interests. The Court held that this venture was not an association.

Conversely, there are comparatively few cases in which the courts or Board of Tax Appeals have held oil trusts to be taxable as associations. With one of these decisions, that of the Ninth Circuit Court in *Twin Bill Oil Syndicate v. Commissioner*, 70 F. (2d) 402 (C. C. A. 9th, 1934), reversed by this Court 293 U. S. 312, 55 S. Ct. 174 (1934), we are in full accord. We invite, however, a comparison of the corporate attributes of the Twin Bell Oil Syndicate with those of E. E. Combs Well No. 2 Express Trust. We believe that this Court will agree that there are almost no elements of essential similarity.

We submit that this trust was neither organized nor operated along the forms, methods, and manners of a corporation and therefore is not an association taxable as a corporation.

Conclusion.

The decision of the Circuit Court of Appeals for the Ninth Circuit, that the trust herein involved is not an association taxable for income tax purposes as a corporation, should be affirmed for the reasons that:

(1) The test as to whether an association exists is two-fold and requires (a) business purpose, and (b) organization and operation along the modes, methods, and manners of procedure of a corporation.

(2) The trust herein involved, even assuming that it was engaged in the transaction of business for profit, was neither organized nor operated along the forms, methods and manners of a corporation.

Respectfully submitted,

LATHAM, WATKINS & BOUCHARD,
DANA LATHAM,
MILLER, CHEVALIER, PEELER & WILSON,
MELVIN D. WILSON,
Attorneys for Respondents.

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